LIGHTHOUSE
INVESTMENT SERVICES

"Every half-baked expert in the world is telling you that you have got to be in cash or in fixed interest. Equities is a much less-loved asset class than it was five years ago, so I think the stockmarket actually is not a bad place to be."

John Sevior, 27 September 2012

The "Price To Earnings Ratio" (PE ratio) is a measure of how much you pay for an after-tax earnings stream. A business that has a market capitalisation of $100 million and after-tax profit of $10 million has a PE ratio of 10. If it has after-tax profit of $20 million it has a PE ratio of 5. Although it is a blunt measure and should not be relied on alone, in general terms the **lower** the PE ratio the **better**. The higher a PE ratio, the greater the amount of future earnings growth required to justify paying that price. The average historical PE ratio of the Australian sharemarket is around 14.5.

If we measured the return of cash in terms of a PE ratio we would see that it is currently around 40 and that of term deposits is around 32. This is exceptionally high for an asset with no potential for earnings growth and is around the levels attained by "growth stocks" during the dot com mania of the late 1990s. Back then people were prepared to trade today's earnings for the prospect of much higher earnings tomorrow; today they are prepared to trade today's earnings for the preservation of their capital tomorrow. We have seen the transformation from a "glass half full" market to a "glass half empty" market in the course of a decade.

Back on 9 March 2000, accompanied by a great deal of media fanfare, BT launched its TIME Fund to invest in Technology, Internet, Media and Entertainment businesses. The NASDAQ reached its all time peak on 10 March 2000 before crashing in April. Global markets followed suit. The worst affected sectors were the technology, internet, media and entertainment ones. A unit in the TIME fund (since renamed the BT Technology Fund), bought for $1.00 is now worth less than 32 cents and the fund has paid no income to investors, a compound annual loss of 8.8% over twelve and a half years.

In July this year Betashares, a manager of Exchange Traded Funds, launched what it calls its "Bear Fund". This is a fund designed to take advantage of a falling market. If the value of the market goes down the value of units in the Bear Fund will rise, and vice versa. It is early days yet but with the Australian sharemarket up 6.6% over the September quarter (plus dividends) the launch of the Bear Fund is looking like it might be about as well timed as the launch of the TIME Fund.

September 2012